

Hotel California:
California Income Tax Issues to
Consider for Cross-Border Trusts
& Estates

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Slide 3	Considerations in choosing fiduciaries (including trustees) inside or outside California and inside or outside the US
Slides 4-5	Addressing California “throwback tax” on accumulated income distributions
Slide 6	How to create a California foreign grantor trust on purpose
Slides 7-10	California rules for income taxation of non-grantor trusts with or without California trustees and beneficiaries
Slide 11	Exit Door Options for Trusts

California Income Tax Issues to Consider for Cross-Border Trusts & Estates

Considerations in choosing fiduciaries (including trustees) inside or outside California and inside or outside the US

- If a California trustee is chosen to be among the trustees, then so long as the trust is a grantor trust, California conforms with federal grantor trust laws. However, at any time the trust is not a grantor trust, then California will generally tax any non-grantor trust income from outside California using the following factors:
- First, whether there are any discretionary or mandatory distributions required to be made to a California resident
- Next, for any discretionary (non-mandatory) distribution whether any fiduciary is domiciled or resident in California – for this purpose, a fiduciary may be the trustee, a trust protector who has obligations to act, an investment manager who has duties, or any other person with fiduciary duties in administering the trust or its assets. If there is more than one fiduciary, then it may be taxable on its non-California-source income based on the proportion that are California residents.
- See Steuer v. Franchise Tax Board (A154691, June 29, 2020, First District, California Court of Appeal) for a good summary of the parameters of the law works.

- A. For US income tax, a non-grantor foreign trust that accumulates income that might be distributed to a US beneficiary and then in a later year distributes it can cause there to be a federal-level interest charge on a daily basis on the accumulated income pursuant to a FIFO regime in order to counter what is viewed as an otherwise effective means of deferral. In addition, the accumulated income is taxed to the beneficiary as the bracket which applied to the beneficiary in the year in which the income was earned and treats realized gains as part of that income.
- B. This federal throwback tax can only be avoided with current distributions being made of income and gains to its US beneficiaries.

Addressing
California
“throwback
tax” on
accumulated
income
distributions

- C. California has its own throwback tax, but it is not as severe because the normal limitation period applies.
- D. The lurking problem with California throwback tax is that California may treat a trust that is not a grantor trust for US purposes as a foreign trust for California tax purposes. For example, a Nevada trust with Nevada trustees that accumulate income for a California beneficiary will be subject to California's throwback tax even though for US purposes it is not a foreign trust for US purposes.

Addressing
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A) If a US person transferor is not concerned about a mark-to-market event causing gains to be realized, then such a transferor could create a foreign trust that is a completed gift for estate and gift tax purposes under IRC 679. With no loss recognition available, this would not typically be done with assets having any unrealized losses but instead with only cash. From there, the trust could buy assets from the grantor as any other grantor trust as long as the value of the assets and the cash matched. See Treas. Regs. 1.679-4(b)(1).

B) However, if the US person transferor does not want to risk realizing the gain from a deemed sale that might result because of problems with the beneficiaries being US persons in any future year, the grantor could create the trust an otherwise normal grantor trust under IRC 671 separate and apart from IRC 679. See IRC In this case, the deemed gain will not occur upon contribution of appreciated assets. See Treas. Reg. 1.684-3(a).

C) Remember that for California purposes, it conforms with federal grantor trust rules. So it will be treated as owned by the grantor and taxable to the grantor in any year that it is a grantor trust. If the grantor is no longer in California when a transaction occurs with a third party while the trust is a grantor trust, California will not tax it even if one of the trustees is a California resident and there will not be a throwback tax relating to that period it is a grantor trust.

How to create
a California
foreign
grantor trust
on purpose

California rules for income taxation of non-grantor trusts with or without California trustees and beneficiaries

- A) It is worth reading the poorly worded tax provisions in the California Revenue and Taxation Code.
- Rev. Tax Code 17734:
- For purposes of computing “taxable income of a nonresident or part-year resident” under paragraph (1) of subdivision (i) of Section 17041, in the case of a nonresident beneficiary, income and deduction derived through an estate or trust shall be included in that computation only to the extent that the income or deduction is derived by the estate or trust from sources within this state.
- Rev. Tax Code 17742:
- (a) Except as otherwise provided in this chapter, the income of an estate or trust is taxable to the estate or trust. The tax applies to the entire taxable income of an estate, if the decedent was a resident, regardless of the residence of the fiduciary or beneficiary, and to the entire taxable income of a trust, if the fiduciary or beneficiary (other than a beneficiary whose interest in such trust is contingent) is a resident, regardless of the residence of the settlor.
- (b) For purposes of this article the residence of a corporate fiduciary of a trust means the place where the corporation transacts the major portion of its administration of the trust.

Note: The “poorly worded” description is taken from the cases trying to interpret them.

California rules for income taxation of non-grantor trusts with or without California trustees and beneficiaries

- Rev. & Tax 17743:
- Where the taxability of income under this chapter depends on the residence of the fiduciary and there are two or more fiduciaries for the trust, the income taxable under Section 17742 shall be apportioned according to the number of fiduciaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.
- Rev. & Tax 17744:
- Where the taxability of income under this chapter depends on the residence of the beneficiary and there are two or more beneficiaries of the trust, the income taxable under Section 17742 shall be apportioned according to the number and interest of beneficiaries resident in this state pursuant to rules and regulations prescribed by the Franchise Tax Board.

California rules for income taxation of non-grantor trusts with or without California trustees and beneficiaries

- Rev & Tax 17745:
- (a) If, for any reason, the taxes imposed on income of a trust which is taxable to the trust because the fiduciary or beneficiary is a resident of this state are not paid when due and remain unpaid when that income is distributable to the beneficiary, or in case the income is distributable to the beneficiary before the taxes are due, if the taxes are not paid when due, such income shall be taxable to the beneficiary when distributable to him except that in the case of a nonresident beneficiary such income shall be taxable only to the extent it is derived from sources within this state.
- (b) If no taxes have been paid on the current or accumulated income of the trust because the resident beneficiary's interest in the trust was contingent such income shall be taxable to the beneficiary when distributed or distributable to him or her.
- (c) The tax on that income which is taxable to the beneficiary under subdivisions (a) or (b) is a tax on the receipt of that income distributed or on the constructive receipt of that distributable income. For purposes of this section income accumulated by a trust continues to be income even though the trust provides that the income (ordinary or capital) shall become a part of the corpus.
- (d) The tax attributable to the inclusion of that income in the gross income of that beneficiary for the year that income is distributed or distributable under subdivision (b) shall be the aggregate of the taxes which would have been attributable to that income had it been included in the gross income of that beneficiary ratably for the year of distribution and the five preceding taxable years, or for the period that the trust accumulated or acquired income for that contingent beneficiary, whichever period is the shorter.
- (e) In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within 12 months prior to the date of distribution of accumulated income and returns to the state within 12 months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution.
- (f) The Franchise Tax Board shall prescribe such regulations as it deems necessary for the application of this section.

California rules
for income
taxation of
non-grantor
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California
trustees and
beneficiaries

- Rev & Tax 17760:
- Section 684 of the Internal Revenue Code, relating to recognition of gain on certain transfers to certain foreign trusts and estates, shall not apply.

Exit Door Options for Trusts

- While estates for a California decedent cannot exit California, a trust may exit California.
- Irrevocable trusts established by Court order with continuing jurisdiction must seek either a transfer order or go through a decanting under California's version of the Uniform Trust Decanting Act. See California Probate Code Sections 19501 et seq.
- Other irrevocable trusts can exit by eliminating California domicile and residence of fiduciaries through either them leaving California or choosing new ones. This can be accomplished if the terms of the document allow for it, by going through the decanting process, or by court order for modification. For the modification grounds, see California Probate Code Sections 15400 et seq.
- Every person with a fiduciary duty needs to be addressed to assure a complete exit.

Questions?

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